

REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOCIATION

May 1, 2007

Dear Mr. Secretary:

Since the Committee's previous meeting in February, the economic expansion has continued on a relatively slow track, dominated by the drag from the housing market correction. Despite a strong gain in consumer spending, the initial estimate of first quarter GDP rose only 1.3%, capping a year of below-trend growth. Although homebuilding has fallen sharply, inventories are still high after disappointing sales this winter, and the loss of the marginal buyer may further delay a rebound. Nonetheless, strong corporate profits in most sectors are underpinning a healthy job market and along with reasonably supportive financial conditions, suggests the expansion will return to trend gradually in coming quarters.

The slowing in economic growth has had a moderating effect on core inflation but elevated energy and food prices along with higher costs for medical services have kept alive upside concerns. Declines in housing and motor vehicles softened prices for a wide range of consumer durables late last year as firms sought to unload unwanted inventory. As a result, the core CPI has drifted down from a peak near 3% to about 2½%, while the Federal Reserve's preferred gauge, the core consumption deflator, is rising at a 2¼% rate. Although modest further improvement is possible, policymakers remain focused on still relatively tight labor markets and the risk of heightened cost pressures as rising compensation overtakes slowing gains in productivity.

In light of the tension between slower growth and core inflation and still limited signs of spillover from housing to consumers, interest rates have edged down but remain in very narrow ranges. Yields across the U.S. Treasury yield curve have dipped by roughly 20 to 30 basis points since early February but market participants have pushed back into 2008

expectations for anything more than a token retracement of previous Federal Reserve rate hikes.

The Federal Government's fiscal balance continues to improve and probably will fall to below 1.5% of GDP in fiscal year 2007 as tax receipts are being buoyed by still solid job growth and rising investment income.

The Treasury opened the meeting by presenting the recently released "Quarterly Refunding Charts" dated April 30, 2007 and a new exhibit labeled "Presentation to the Treasury Borrowing Advisory Committee" dated May 1, 2007.

The refunding chartbook highlighted the continued improvement in the near-term outlook for the fiscal budget and a commensurate decline in net marketable borrowing needs. In fact, the net marketable borrowing needs have been further reduced by a recent increase in the issuance of state and local government securities (SLGS).

The Treasury is now estimating a net marketable pay down of \$145 billion of debt this quarter and net marketable borrowing needs of \$43 billion next quarter. These figures have improved by \$15 billion and \$6 billion, respectively, since January and are much improved relative to earlier forecasts.

The fiscal outlook has improved as individual and corporate tax receipts have continued to outpace estimates and while, at the same time, fiscal year outlays on a year-to-date basis are registering their smallest growth rate in recent years.

Against this backdrop of continuing improvement in the near-term fiscal outlook, the Treasury's first charge to the Committee was to solicit our advice with respect to the Treasury's debt issuance schedule.

After some discussion, the Committee concurred with Treasury that it had largely exhausted its flexibility with reduced bill issuance in response to a marked improvement in borrowing needs. Consistent with its earlier advice, the Committee recommended the elimination of the quarterly issuance of three-year securities.

Several members pointed out that the three-year note, which had only been re-introduced into the regularly scheduled coupon calendar in 2003, was the most appropriate security to be eliminated given the prospects for near and intermediate term borrowing needs. While three-year notes have served the Treasury very well over the past four years and have strong market acceptance, they are deemed less valuable than the 2-year, 5-year, 10-year and 30-year coupons which are the primary benchmark securities along the government yield curve.

The Committee also discussed the potential need to consider other measures over time if the fiscal outlook remains strong or improves even further. For example, several members again suggested that 5-year TIPS are a security that offer little investor value

and have been held and traded primarily by investors and speculators responding to and anticipating near-term changes in commodity prices and CPI measures.

Not all members agreed, however, with the recommendation to consider this security for elimination if needed and thought that it might be more appropriate to consider other measures.

Finally, many members of the Committee commented on the unpredictability of the budget and noted how volatile the estimates have been in the past and that the Treasury should be cautious in making significant further adjustments in debt issuance in the near term. For example, several members pointed to the recent slowdown in GDP, the discussions surrounding adjustment to the alternative minimum tax (AMT) and other factors that should give the Treasury pause before making significant changes in its debt management schedule. Furthermore, the difficult fiscal environment predicted for the next decade and beyond by Social Security and other entitlement programs cannot be ignored.

In the second part of the charge, a Committee member presented his thoughts on U.S. Treasury debt management within a framework of improving fiscal trends. This member addressed the question of volatility in budgetary forecasts and whether Treasury had at its disposal sufficient tools for an improving fiscal or surplus environment.

The presenting member focused his commentary on the areas of debt management, cash management and risk management.

This member opined that in the area of debt management, or the construction of the portfolio, Treasury has excellent tools and has done a good job of making adjustments as needed. In the past, Treasury has first focused on the size of issues and then the frequency of issuance and ultimately the need to add or eliminate entire issues as appropriate. Treasury has effectively taken into account liquidity considerations, satisfying the important objective of achieving a regular and predictable issuance profile.

Re-openings were cited as another effective tool and, along with buybacks, provided Treasury with significant degrees of freedom in their issuance programs.

This member concluded strongly that Treasury has the tools to manage its debt portfolio in any reasonable fiscal environment.

In the area of cash management, this member posited that Treasury could do more to improve its effectiveness at managing the significant volatility of cash balances. By having an ability to invest high cash balances more dynamically or to operate in repo markets, Treasury would insure against the risk of reinvesting balances below market rates.

He concluded that Treasury could invest more in risk management resources and would be well served to study the example of other sovereign debt management programs in surplus environments, such as Australia and Canada.

Several members commented on the success of the buyback programs in prior periods and the importance of retaining and refining that tool given the pace of change in fiscal outlooks.

A strong majority of the Committee agreed with the proposition that Treasury has effective tools to administer debt management and that it should investigate the use of additional tools for cash and risk management purposes.

For the Treasury's third charge to the Committee, views were solicited as to the trends in international capital and investment flows and how these flows may affect the Treasury's mission.

One member of the Committee prepared a chartbook labeled "Trends in International Investment" and walked the group through the exhibits with commentary. The exhibits highlighted the increased cross-border activity in financial markets and investment by private and public investors.

Several of the exhibits highlight the growth in purchases of US securities by non-U.S. investors. For example, the annual net purchases of U.S. securities in 2006 by non-U.S. investors is estimated at a little more than \$1.1 trillion with the bulk of that, or approximately \$1 trillion, used to purchase U.S. debt securities. While the total investment in U.S. securities by foreigners has grown, the bulk of that growth has been in non-Treasury instruments such as agency and corporate notes and bonds and, while smaller in size, in equities.

The member also pointed out that while there has been tremendous growth of foreign investment in our securities markets, the U.S. remains a major investor abroad. For example, U.S. net purchases of foreign long-term securities (equity and debt) recently passed \$20 billion per month on a 12-month moving average basis and has increased markedly over the past several years.

The presenting member offered several conclusions from his presentation. Among them, that foreign capital inflows constitute a rising share of U.S. debt financing and provide lower interest rates than otherwise would occur. And, that the source of foreign inflows are increasingly concentrated in China and oil exporting countries, raising the risk of disruption in the event of protectionist legislation.

The Committee briefly discussed the members presentation and conclusions and were generally in agreement with those conclusions.

One member noted that the accumulation of wealth has occurred so rapidly in many countries that they have reacted by investing in very liquid securities such as fixed

income and are now beginning to broaden their investment policies to include other asset classes. And, additionally, that for many countries, there are and will continue to be pressure for them to invest in infrastructure projects within their own countries.

In the final section of the charge, the Committee considered the composition of marketable financing for the April-June quarter to refund approximately \$54.6 billion of privately held notes maturing on May 15, 2007, as well as the composition of marketable financing for the remainder of the April-June quarter, including cash management bills, as well as the composition of marketable financing for the July-September quarter.

To refund \$54.6 billion of privately held notes and bonds maturing on May 15, 2007, the Committee recommended a \$14 billion 3-year note due May 15, 2010, a \$13 billion 10-year note due May 15, 2017 and a \$6 billion re-opening of the 30-year bond due February 15, 2037. For the remainder of the quarter, the Committee recommended an \$18 billion 2-year note in May and June, a \$13 billion 5-year note in May and June and an \$8 billion re-opening of the 10-year note in June. The Committee also recommended a \$25 billion 14-day cash management bill issued June 1, 2007 and maturing June 15, 2007, as well as a \$12 billion 8-day cash management bill issued June 7, 2007 and maturing June 15, 2007.

For the July-September quarter, the Committee recommended financing as found in the attached table. Relevant features include three 2-year note issuances monthly, three 5-year note issuances monthly, a 10-year note issuance in August with a re-opening in September, a 30-year bond issuance in August, as well as a 10-year TIPS issuance in July and a 20-year TIPS re-opening in July.

Respectfully submitted,

Thomas G. Maheras

Chairman

Keith T. Anderson

Vice Chairman

Attachments (2)

Table Q2 07

Table Q3 07